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Guest: State Treasurer Dean Martin

Welcome Welcome to aztalk Live Talk. Our guest today is state Treasurer Dean Martin.

Treasurer Martin, were you surprised the $700 billion Bush-Congress bailout plan for Wall Street failed on Monday? And what do you think of its chances for being resurrected?

I think this was a failure of leadership on both sides. Congressional leadership announced several times over the last week they had a deal on framework, then a deal on language, then a deal on the votes. Everyone was taking great care to be bi-partisan or non-partisan. However when it came time to vote, they could not resist in an election year to start pointing fingers and making partisan remarks that blew up a very tenuous deal. I was surprised that they would let their election year partisanship be injected into the situation BEFORE the vote was over. It's like putting out a fire; you fight the fire first, then you send in the arson investigators to figure out who to blame. Of course we are talking about Congress (in an election year) so I guess we should be surprised they even got as far as they did before blowing it up with cheap partisan rhetoric.

You were against the bailout in its initial form? Are you in favor of some sort of bailout, and what needs to be accomplished in a bill that would be acceptable?

I strongly believe that action is needed to stop the financial meltdown. I just think the initial solution was a very expensive way to solve the core problem creating the credit crisis. Our financial system is in a logjam, gripped by fear. We were de-leveraging slowly before the Feds' schizophrenic behavior two weeks ago that forced A rated investment bank Lehman Brothers into bankruptcy. This was like dumping dynamite into the financial markets and is the root cause of the magnitude of the present crisis. As a result we are now we are in a panicked "fire-sale" of rapid de-leveraging.

The solution that failed earlier this week just treated the symptoms of the problem in a very expensive way. We need to treat the disease, not just the symptoms. At its core, the problem is crisis in confidence in the housing market (mortgages) and a poorly drafted accounting rule "mark-to-market" that does not account for the possibility that there would not be a liquid market for every possible asset.

When mortgage markets froze last August, demand evaporated for the now-toxic mortgage bundles. This crushed many banks' balance sheets as they had to list mortgages at pennies on the dollar. Instead of having these assets on the books as collateral to make more loans, banks now needed to borrow money to stay afloat. Banks, however, stopped lending to other banks due to fear of getting indirect exposure to subprime loans. Banks depend on short-term cash to stay afloat. A total credit freeze puts our financial system in peril.

Congress must act; the longer they take, the more expensive this will be. Buying up every bad debt may work (as they proposed in the plan that failed), but they really need to fix the fundamental reasons for banks not lending. 90% of Americans are still paying their mortgages. However the accounting rules do not let 90% of mortgages be valued at their current performing status. No investor wants to buy mortgages since there was little transparency the securities, and they do not want to take on any sub-prime losses. All mortgages are being de-valued in the market, so if they sell at all, they sell at 10-20% of their value. As long as 90% of performing loans are on the books as 10-20% value, banks will need to borrow more money to keep reserves in place. When banks are borrowing, they can't be lending. We need to insure the 90% of mortgages that are performing (this rewards all homeowners that have been good about paying their bills). This would allow banks to put the real value of mortgages on the books at 90%. Investor confidence will return with the insurance, and therefore investors will be able to buy them since they will be appropriately valued and become an asset rather than liability. Without fixing the core problem, we are at risk to repeat this crisis again and again. This is a much less costly method of breaking the logjam in the credit markets than buying all the logs. The American people will prefer a method that saves taxpayers money and protects those who have not taken excessive risks and are paying their mortgages.

The more pressure we can put on Congress to limit the impact to taxpayers, the more support from the general public will be gained. The more public support in an election year means more votes in Congress, votes that obviously are needed right now.

Action is needed immediately, but taxpayers should not pay for others' mistakes. The last thing we need is FEMA running our local bank.

We need to stop the wildfire that threatens the entire financial system. Congress does need to act. Because over the next hill are not just banks, but people's savings, homes, and jobs. If this crisis is allowed to continue, the threat to jobs and retirements are very real.

Did John McCain suffer politically when House Republicans voted against the bailout bill? McCain had prematurely taken credit for rallying Republicans to pass it after dramatically suspending his campaign and returning to Washington, D.C., and McCain failed to even get a single Arizona delegate to vote in favor of the bill.

I don't think you can blame any Senator for the failure of leadership and partisanship in the House. The Senate has remained very bi-partisan on this issue. I think that people will know the difference, and today in polls McCain's numbers have actually gone up. They all need to roll up their sleeves to solve this problem quickly, which ironically is exactly what McCain was proposing last week before the debates. I think voters are now, after a record drop on Wall Street Monday, looking back on his comments with greater respect.

The stock market closed Monday after dropping 777 points after Congress failed to pass the bailout bill. Does this show just how fragile our economy has become and how much Wall Street needs the infusion of cash and relief of debt? Or is Wall Street wrongly counting on this bailout and forcing Congress' hand?

The Feds created this mess when they bailed out Bear Stearns then refused to help Lehman, then nationalized AIG an insurance company, then let WaMu and Wachovia go under. This schizophrenic behavior has created a panic on both Wall Street and Main Street. Then Congress spends the next week telling everyone that they will come to the rescue, and the markets priced that into their investments. When the House failed the bill, that expectation came out of the market. Markets depend on government to be the fair referee in the game, and not pick winners and losers. They need to be predictable in their actions. Their behavior has been just the opposite and it has had the effect of pouring gasoline on the fire. At this point they have created such a mess, the fire is so out of control, the only organization that could possibly bring the panic to a stop is the federal government. Things should never have been allowed to get this far out of control, but now is not the time to point fingers; there will be plenty of time for that later. We need action right now.

How much did Arizona lose because of the failure or buyouts of top financial institutions? How much more is at risk? Did municipalities also lose millions?

We made and distributed to the State and 140 local governments over $502,385,363 in profits last fiscal year; that's over half a billion dollars. We are still making millions today even in this market. So far in the first two months of this fiscal year we have made and distributed $46 million in profits.

We diversify our portfolio in order to reduce a concentration of risk. Out of our $12 billion dollar portfolio only 0.3% was in Lehman Brothers. Even if the bankruptcy court forgives all debts (unlikely) we will still make hundreds of millions of more money for state and local governments. Effectively we won't make as large of a profit this year due to the current market conditions, but everyone will still make more money than if they did not invest.

We have taken extraordinary measures to reduce our exposure to areas affected by the current crisis. Over 70% of all our investments are in US Treasury bonds or US Government backed investments. Safety is our first priority.

The real concern in this crisis is what it will do to the economy. If this crisis lasts into the holiday shopping season, we will have a very blue Christmas. This will mean significantly lower tax revenues to government (which also means we will have less to invest). This is why action is needed soon.

Some people are comparing our economy to 1929, talking Great Depression. Is there an exaggeration of the scope of financial distress and danger, or is the threat real?

I do not think the country will make the same mistakes as the Great Depression; Congress will make all new ones.

However the threat of a complete financial system meltdown is real; the Great Depression was much more than just a financial meltdown, but that is where it started.

Have you ever met Treasury Secretary Paulson? And how well do you think he's handling the nation's financial crisis?

I met Paulson once last March at a National Treasurer's conference in DC. We had a closed door meeting with just State Treasurers. I asked him about how they were going to address the problems of Freddie and Fannie, and if they will continue to remain the lender of last resort as they have been since the Great Depression. I found his answers evasive. They were not reassuring that they were going to act decisively and consistently. The Feds' schizophrenic behavior two weeks ago has not helped the markets or my opinion of his handling of the situation. Although he has more data about what is going on, I think they could have prevented the current crisis by being more consistent and transparent by making smaller loans to retail banks to buy failing investment banks (like they did for JP Morgan who bought Bear Stearns).

Let's talk a bit about Arizona's own financial troubles. We're staring at a $1 billion deficit. Is the answer finding new revenue -- such as the new speed cameras, cutting programs, raising taxes/fees or all or none of the above?

First, when you are in a hole, STOP DIGGING! They have added several billion dollars of additional spending during this downturn. That has made the state very vulnerable to the current crisis. They spent the savings account last year, they maxed out the credit cards this year, and they pushed $1.5 billion of spending this year off the books to July of 2009. They need to stop adding new programs and spending to get this problem under control. They need to also roll back all the new spending they promised the last two years but now cannot afford. Massive cuts will be necessary if the spending growth added the last two years are not rolled back. Otherwise tax increases will be likely, but the worst thing they could do to the Arizona economy is raise taxes on consumers and businesses struggling in the current economy. I was warning about this looming budget problem back in February of 2007 (and was called Chicken Little for doing so). Hopefully they will listen now.

Do you see the Arizona economy picking up in the next few years, with building and the real estate market returning? Or is this the new normal -- hard times ahead for the foreseeable future?

I was predicting a recovery beginning next year before this current crisis began.

However even with Congress acting, just the impact of the failures of Lehman, WaMu, and Wachovia will delay any recovery by six months. I am now forecasting that a recovery will begin, at the earliest, a year from now. If Congress fails to act at all, or allows this meltdown to continue another week or more without action, the recession will be much longer and more severe.

Our housing market will return. But we estimate 67,000 homes were built in Arizona during the boom without any population growth to live in them (over-speculation). This will take time for population to move here to buy that excess supply. We have to wait until the national housing market returns before we can begin our recovery. People in Minnesota need to be able to sell their houses there, before they will buy one in Arizona. Demand has to catch up with our excess supply.

What should Arizonans know about their investments but likely don't?

The Treasurer's office is actually one of the largest banks in the State. We took over $39 billion in deposits last year. We average about $12 billion in assets invested at any one time. We complete about 300 trades averaging $1-$2 billion each day. Last year we made over $1 TRILLION in investments, and distributed profits of over half a billion dollars back to the State and local governments that participate in the joint pool. By pooling state and local government money together, we are able to make larger profits for both, at a lower cost, than anyone could do on their own.

What kind of phone calls are you getting at the Treasurer's Office from Arizonans? How about state officials, what are they saying?

We are getting a lot of calls from the media to give our perspective on the current crisis. We have gotten a few calls about people's retirements, but the Treasurer's office does not manage the retirement systems so we have been referring them to ASRS, PSPRS, or CORP systems.

We have been on two conference calls with the White House and State Treasurers as well as numerous phone calls with the White House staff and US Treasury Department to make sure they don't ignore the impact on the state and local government investments. Unfortunately, they have not been listening much; they just pushed their plan and did not want suggestions for improvement. Hopefully that stubbornness will subside since the failure of their proposal, and cooler heads will prevail.

We have been in contact with Sen. Kyl's office regarding our suggestions which we put into the Viewpoints article.

http://www.azcentral.com/arizonarepublic/viewpoints/articles/2008/09/28/20080928vip-martin0928.html

Sen. Kyl expressed his agreement with our approach to the problem and that they are hearing exactly the same thing from many other experts in the market. He said we was working with leadership on a hybrid bill that would pass.

Are you finding this job more difficult than you imagined going into it, especially given the tight economy and state budget deficit?

Actually it is a lot more interesting that I expected. The economy is definitely in a crisis right now, but we are making changes and improvements to open up government finances to the public, increase transparency and strengthen checks and balances within state government. I am really enjoying this job since we are able to make lasting improvements to the office.

When people know you're the state treasurer, do they automatically ask you for financial advice?

Yes, especially lately. But I always tell them as Treasurer I have a team of people who make this happen. My office has a staff of less than 30 to manage a $12 billion dollar bank. It is only through the combined effort of all of us that we have achieved so much in a year and a half.

Unfortunately the Governor and legislature refused to listen to our warnings about the state economy slowing and revenues declining. Hopefully now they will start listening!

Mark from Phoenix asks:

Are there inherent reasons why credit unions may be more likely to have mortgage money than traditional mortgage bankers?

Yes, Credit Unions can only raise capital for lending from customer deposits. They are not allowed to raise money on Wall Street. This limits their growth potential and size; however, in this current crisis this means that they do not have exposure to some of the investment risks that other banks have. In addition credit unions were very reluctant to get into the sub-prime lending area, so they rarely have the more troubled mortgages on their books. Every financial institution is affected by this crisis, they just have a more limited exposure and therefore are doing relatively better.

aztalk moderator: Does Arizona need to diversify its revenue methods? Apparently relying mostly on sales taxes isn't working, especially during a down economy with little or no building?

Actually sales taxes have been the most stable of our revenue sources. Corporate income taxes are the most volatile (jumping from plus 36% to -36% in just a year or two). Individual income taxes are the second most volatile with double digit movement possible, positive and negative. Sales taxes are a much more stable tax base for the state. During the last recession (2001-2003) sales tax growth remained positive (although barely) when all other forms of taxation went negative.

The problem is not the source of revenue, during a recession the economy retracts, therefore tax revenues go down, no matter what it is you tax. The problem is a lack of planning for the future. We know recessions happen, but when we had a $2 billion dollar surplus, I could not get the legislature or Governor to lock away more money for the next rainy day.

They refused my proposal for a rainy day fund with teeth, that required more deposits in good times, and would prevent the them from raiding it and draining it in one year (like they did this year) leaving little for the rest of the recession. This budget crisis was caused by a lack of planning for the downturn, and then ignoring it for too long once it started.

Could more regulation of the market averted the present financial crisis?

Yes, but it needs to be the right kind of regulation. There was a lack of transparency in the markets. Mortgages would be bundled together with prime loans being mixed with sub-prime and others. Investors saw an "A" rating and assumed the entire bundle was safe. It was very difficult to find out what was really inside these investments. This needs to change. Transparency in crucial to preventing panic.

Remember the Tylenol poisoning scare of the 1980's . Just a few bottles were poisoned, but people stopped buying any to prevent them getting one out of the millions that had been poisoned. Only until a "safety seal" was put on each bottle so that the purchaser could see if that bottle was safe, did people start buying them again.

We need the same thing for Wall Street. We can't regulate risk out of investments, but we need to make sure that the risks are as transparent as possible. This will prevent panics from beginning, and make sure that people who are investing are not taking on risks that are not properly disclosed.

We also need to look at credit ratings. How can so many "A" rated investments be failing. Investors rely on these ratings. I think we should change the system so that ratings are not bought and manipulated by the organization selling the security. Ratings need to been truly independent.

It seems the new main emphasis for a bailout is not a bailout of Wall Street, but freeing up credit for consumers and small business. Is this simply a new spin -- nobody wants to bailout rich fat cats from Wall Street -- or truly the best if not only reason to vote for a bailout?

This situation is like a wildfire, there is a fire on Wall Street. Left unchecked, the fire will spread down the street to businesses, then down to Main Street and people's daily lives.

Banks right now cannot lend to other banks. The devaluation of mortgages on their balance sheet has spread to all financial sector investments (see "mark-to-market" accounting above). Banks are actually trying to borrow money just to stay within regulated capitalization requirements. When banks are borrowing to stay afloat, they cannot be lending... they don't have the cash. In fact a few days this week we have seen NEGATIVE yields on US Treasury Bonds. This means that demand for "safe" US Government debt so much exceeds supply that you are effectively paying the US government to lend it money.

This is how it spreads to Main Street. Banks can't lend right now. If they can't lend, then employers who depend on short term loans to operate have to close and lay off employees. Farmers need loans to buy seed in the spring, then pay it back at harvest. Auto dealers need loans to buy new 2009 cars for them to sell. Most businesses have irregular cash flows, and in this slowdown people are slower to pay their bills. Short term loans allow the business to fill that gap. Almost every industry is affected, from doctors to farmers to car makers.

It is only a matter of days or a week or so before this crisis on Wall Street results in a crisis on Main Street. Once it spreads to Main Street, and layoffs begin, the recession will get much worse.

Thank you.